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SUBJECT: 2009 BUDGET: FALLING OIL PRICES MEAN CUTS, DEFICIT, DFI DRAWDOWN

REF: Baghdad 449

SENSITIVE BUT UNCLASSIFIED; PROTECT ACCORDINGLY.

¶1. (SBU) Summary: Despite pressures from key members of the Maliki Government for fiscal largesse, Finance Minister Bayan Jabr cut the proposed 2009 budget while it was under consideration by the Council of Ministers (CoM), where it secured approval before moving on to the Council of Representatives. This clears a key hurdle with the IMF, but leaves political difficulties to be overcome before passage. Even with the GoI's uneven record at budget execution, a deficit of this amount will likely entail drawn-down of the GoI's accumulated fiscal surplus in Development Fund for Iraq (DFI). The 2009 budget is constructed with the Kurds taking 17 percent share, however sentiment in the CoR is growing against the size of the Kurdish take.

Oil Price Drop Forces Cuts in Proposed 2009 Budget

¶2. (SBU) The original 2009 budget submitted to the Council of Ministers (CoM) was based on a forecast 2 million barrel per day export sales rate at USD 80 per barrel. Oil exports make up 90 - 95 percent of Iraq's budget revenues, so this allowed the budget to be formulated with USD 58.4 billion of oil revenues. However, oil prices have dropped sharply since Finance Minister Jabr agreed to this estimate with the IMF at the Bank/Fund meetings in October. While the budget was under consideration by the CoM in early November, Jabr was forced to make significant budget reductions to adjust to dramatically lower estimates of 2009 oil revenues.

¶3. (SBU) This process started with meetings between Iraqi government officials and the IMF mission in Amman, Jordan the week of October 27. Based on these conversations, the broad form of a new budget package emerged. Most notably, the agreement with the IMF included cutting the oil price forecast to USD 62.50 per barrel, and reducing the total budget envelope from USD 78 billion to 67 billion, while still preserving a USD 14 billion capital program (reduced from 19 billion USD). The resulting 15 billion USD deficit is roughly equal to that forecast in the initial budget submission.

Revenue forecast remains aggressive

¶4. (SBU) The revised revenue forecast is based on 2 million barrels per day of exports sold at USD 62.50 per barrel, which equates to USD 45.6 billion, a 22 percent decline. Partially offsetting this, other revenue is forecast to increase from USD 4.0 billion, to 6.0 billion. The combination creates a total revenue forecast of USD 51.6 billion.

¶5. (SBU) COMMENT: Despite the 17 percent decline in forecast revenue, several aspects of the GoI projection are optimistic. There seems little justification for the USD 2.0 billion increase in other revenue. The only time Iraq had this amount of non-oil revenue was in 2008, when they realized USD 7.0 billion of revenue from the auction of cell phone licenses. There is no obvious source of any such windfall, nor are there plans to implement tax regimes

capable of accruing that amount of revenue. Moreover, the oil revenue forecast itself may prove optimistic. Iraq has exported at a 1.85 million barrel per day rate this year, and domestic demands are growing, so it will be difficult for Iraq to export at a 2.0 million barrel per day rate, even barring further deterioration in production levels. Moreover, the oil price continues to fall. Minister Jabr noted that recent shiploads have been sold as low as USD 45 per barrel, a price 26 percent below the reduced estimate.
QUSD 45 per barrel, a price 26 percent below the reduced estimate.
End Comment.

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Expenditures will be curtailed, but a sizeable
capital budget will be preserved
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¶6. (SBU) Under the agreement with the IMF, Jabr agreed to cut the overall budget envelope from the USD 78.4 billion originally submitted to the Council of Ministers to USD 67.0 billion, a 14 percent cut. With the Maliki government refusing to pare recently-granted wage increases for government employees, Jabr had little flexibility in reducing operating expenses, which were cut from USD 59.2 billion to 52.6 billion, an 11 percent decrease. According to Jabr, operating expense cuts included reducing the allocation for the Public Distribution System (PDS) from USD 5.8 billion to USD 5.3 billion on the basis of lower world agricultural prices. In addition, planned wage increases for state-owned enterprises were reduced, deferred, or cut altogether. This does not reduce wage costs, but it does reduce SOE subsidy levels. Finally, while funds budgeted for importing electricity (USD 480 million) and fuel for power plants (USD 500 million) were increased in 2009, the total budget outlay does not appear out of line with the relative austerity of the budget construct.

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¶7. (SBU) From a technical standpoint, the MoF made a number of changes in the 2009 budget. These will increase transparency of SOE finances, and hopefully will lead to better management. Direct budget subsidies to the SOEs were formerly budgeted in the MoF Subsidies chapter. Now, the cost of subsidies has been moved to the Ministry responsible for the relevant SOE. In the 2009 budget plan, no Ministry of Oil (MoO) SOE will receive any subsidy, but several units of the Ministry of Electricity (MoE) will continue to receive transfers from the GoI budget. At the same time, both the MoO and MoE will receive large increases in their Goods and Services accounts, with the MoE increasing from USD 30 million in 2008 to USD 1 billion in 2009. MoE Goods and Services will increase from USD 90 million to USD 940 million. Moving these amounts to the parent ministry from the SOE will provide a better understanding of how these ministries operate from a financial perspective.

¶8. (SBU) With operating expenses relatively inflexible, Jabr did well to preserve a capital budget of USD 14.3 billion, a cut of 25 percent from the USD 19.2 billion capital budget originally developed. However, there are some changes in individual budget lines that merit additional comment. For example, the Ministry of Oil capital budget remains untouched at USD 2.6 billion. The Ministry of Electricity budget was cut from USD 2.4 billion to 1.3 billion. There is a full project list against this budget, so it leaves the question of where funding for the multi-billion dollar GE turbine procurement will be sourced. Also, despite being politically popular, for the first time provincial allotments have been reduced - essentially being halved from USD 5.1 billion to USD 2.5 billion. (COMMENT: Planning Minister Baban had earlier expressed his concerns at the level of capital budget cuts fearing they would hamper efforts to diversify Iraq's economy. A separate report will be written on his reaction to the final bill. End Comment).

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Budget deficit forecast. Drawdown of DFI
reserves seems inevitable
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¶9. (SBU) The forecast budget deficit for 2007 and the 2008 base budget ranged around USD 7.5 billion. The initial 2009 budget

effectively doubled the forecast deficit to USD 15.9 billion. The revised forecast cuts the deficit slightly, to USD 15.3 billion, but it remains almost 23 percent of total budget. This approaches the outer bounds of what the IMF will agree. Fund Staff told TREASATT they want to see a budget deficit below 10 percent, but they will develop independent cash projections based on the official GoI forecast. However, the GoI has good success spending its operating budget, and with nearly 80 percent of all expenses in the 2009 budget coming from the operating budget, under spending may not be as pronounced as in previous years.

¶10. (SBU) The MoF forecast budget deficits in each of the last five years. However, each year has concluded with a surplus, as actual spending has underperformed programmed levels. As a result, the MoF has an accumulated fiscal surplus, which includes USD 21.2 billion in the DFI and an additional 4.3 billion U.S. Dollar balance at the Central Bank. Both Minister Jabr and the IMF are prepared to see these balances fall this year, as accumulated reserves fund any budget deficit. However, neither is prepared to countenance a precipitous drop, nor are they prepared to see these reserves committed in bulk to a single capital investment program, no matter Qcommitted in bulk to a single capital investment program, no matter how dire the need in Iraq.

No Roll-over of 2008 Funds

¶11. (SBU) Previously, the MoF allowed provinces to carry over unspent balances from the current year for use in the following year. This was done to give the provinces, which had received separate capital funding allocations only since 2005, more time to work their capital programs through the MoPDC and MoF. The 2008 budget law allowed both ministries and provinces to carry over unspent capital funds (the 2007 budget law permitted only the provinces to carry-over), as the GOI wanted to improve rates of expenditure and utilization of funds. This was popular with spending units, but it played havoc with a cash-based accounting system based on an annual cycle.

¶12. (SBU) The initial 2009 budget submission contained a provision that would allow both ministries and provinces to carry-forward unspent balances in their capital budgets, as was done in 2008. This was seen as necessary, as the USD 22 billion supplemental budget was only enacted in September, leaving little time to expend it in compliance with unwieldy GOI procedures before year-end. However, as part of his agreement with the IMF, and to conserve cash, Jabr removed the 2009 carry-over provision. Without such a provision, the MoF effectively will freeze budget execution on December 31. Any programs not contractually committed at that time will need to be converted to 2009 funding. As such, withdrawing the

carry-forward provision is a backhand way to curtail spending programs. At the same time, it reduces the amount of cash flowing out of the DFI to fund 2008 capital expenditures, so it increases the cash buffer available to fund deficit spending in 2009 and beyond.

Disgruntlement Growing Over Kurdish Share

¶13. (SBU) Both the initial submission of the 2009 budget and the revised version call for the Kurds to receive 17 percent of the budget after deduction of "sovereign expenses." According to Jabr, this is a rational apportionment that goes back to the time of Ali al-Alawi, Jabr's predecessor as Finance Minister. Jabr is prepared to change this percentage, but only based on an objective measure. The 2008 budget called for a census to fix a percentage share for the Kurdish regions based on population, but the census has been postponed to late 2009, and Jabr feels compelled to stay with the 17 percent. Jabr added that while the Kurdish share of the budget remained controversial, the question of funding for the Peshmerga, which was one of the issues behind the delayed passage of the 2008 budget, had fallen into the background. The GoI is now unified around the position that the Peshmerga would only be funded by the

central government budget when it fell under Iraqi Army command, a position which the Kurds find unacceptable. With no way to resolve this impasse, debate has moved to other issues.

¶14. (SBU) Minister Jabr expressed optimism that a census would be conducted in 2009, as it is long overdue and a wide range of GoI programs (i.e., PDS) would benefit from an accurate population count. Jabr noted that a new provision on this score was inserted into the 2009 budget legislation to allow adjustment of the KRG share should the census conclude that the Kurdish share of the budget was unrepresentative of actual population distribution. Jabr believes this will mollify certain Shia and Sunni groups who believe the Kurds are getting an unfair share of the national budget, but Kurdish elements can be expected to react adversely.

¶15. (SBU) Jabr has also indicated that pressure was building with regard to the Kurdish share of the GoI budget. "A number of CoR members were furious at Kurdish maneuverings in regard to this year's Supplemental Budget, which substantially increased the funding they received," Jabr told TREASATT. Another thing he pointed out was that when a budget is initially distributed, the Kurds take their 17 percent in full. However, if funds bound for non-Kurdish spending units are not used, they typically are returned to the budget and re-allocated. This gives the Kurds a second 17 percent. And the more times GoI funds are cycled through the budget, the more times the Kurds receive their share. Jabr remarked that many economically savvy CoR members were becoming upset over this issue, particularly when combined with Kurdish intransigence on other issues.

Special Provision for FMS Included in 2009
Budget Law

¶16. (SBU) The PFMAG, working with the MoD, MoI, MoF, Board of Supreme Audit, and the Finance Committee of the Council of Representatives, sought a solution to the issue of reconciling actual deliveries of weapons and other items procured under the Foreign Military Sales (FMS) program with amounts previously budgeted. This inter-agency work led to a decision to allow unspent allocations for weapons and military supplies within the 2006, 2007, Qallocations for weapons and military supplies within the 2006, 2007, and 2008 budgets to be rolled-over into the 2009 financial year. This allows the MoF to record the expense related to millions of dollars of deliveries under the FMS program over these three years. Article 27 of the revised draft budget law puts this approach to resolving past FMS issues into law, eliminating an important impediment to this method of military goods procurement.

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CoR Finance Committee will cooperate to secure
prompt budget passage
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¶17. (SBU) After the meeting with Minister Jabr, TRESATT and Econoff met with Ayad al-Samarai, Chairman of the Iraq Council of Representatives (CoR) Finance Committee to discuss the 2009 budget (septel). Noting the "softness" in oil revenues, al-Samarai is concerned about the level of operating expenses, and will look for additional cuts. With no carry-forward provision, al-Samarai agreed with TREASATT that it is critical to pass the 2009 budget on a timely basis, as capital spending will stall without funds available for expenditure. To expedite passage, al-Samarai told us that the CoR received the budget November 16, and it was go to an immediate first reading, as well as simultaneous beginning of the comment period. (Note: COR consideration of the SOFA has apparently side tracked the budget reading. End note.) Al-Samarai wants to have a second reading after the end of the Haj recess in mid-December, and

he is hopeful that debate and final passage can be completed before year-end. Al-Samarai agreed with Minister Jabr that the Kurdish share of the budget was controversial politically, but he is hopeful that the provision to "adjust" shares in response to census results may placate opposition in the CoR. (COMMENT: The developing close

cooperation between Finance Minister Jabr and Chairman Samarai bodes well for implementation of the GoI fiscal agenda, as well as demonstrating how Shia and Sunni leaders can work together for the benefit of Iraq. End Comment).

Uncertain Future Calls for Restraint

¶18. (SBU) COMMENT: The reductions forecast in the revised budget approved by the CoM and moved on to the CoR embody the fiscal restraint needed as oil prices fall from the heights they reached just a few months ago. Removal of the provision allowing carry-over of the "rich" 2008 capital budget into 2009 aligns the capital budget with a realistic rate of spending. Nevertheless, it seems inevitable that Iraq will need to tap into its accumulated fiscal surplus during 2009. However, this is not a permanent source of funding, and as a result, 2009 may represent something of a watershed year for Iraq. If oil prices do not recover, or if they decline further, the GOI may have to force a true fiscal austerity budget through the CoR beginning with the 2010 budget and prepare the reforms needed to make Iraq an attractive market for international capital. End comment.
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